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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes	)	**CC Docket No. 92-133**

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COMMENTS OF CENTRAL TELEPHONE COMPANY

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SUMMARY

Central Telephone Company ("Centel"), on behalf of itself and its affiliated local exchange carriers ("LECs"), hereby submits these comments in response to the Commission's Notice of Proposed Rulemaking, CC Docket No. 92-133, FCC 92-256, released July 14, 1992. Centel supports the Commission's efforts to reform the interstate rate of return process.

Centel favors the use of a semi-automatic trigger for determining when to initiate future rate of return represcriptions. A market based, objective measure, such as Moody's Aa utility bond yields, should be used for the trigger since it is a regularly published figure.

The trigger mechanism should be based on a deviation for six consecutive months of +/- 150 basis points in the six-month moving average of the Aa utility bond yield for a base rate Aa utility bond yield. The initial base rate should be set at the conclusions of this proceeding. A band of +/- 150 basis around a base rate based on the six-month moving average would provide a reasonable measure of significant and persistent changes in LEC capital costs. In addition, the trigger mechanism should include a requirement that Aa utility bond yield for the most recent month should also be outside the +/- 150 basis point band. This requirement would avoid an unnecessary represcription proceeding where the credit market is correcting itself. Once the triggering events have occurred, the Commission should analyze the rates of interest on futures contracts to determine whether

to conduct a represcription proceeding. Where the forward rates of interest are not expected to vary significantly from the base rate, a represcription proceeding may not be necessary.

Centel supports the Commission's efforts to streamline and simplify the conduct of represcription proceedings and urges the Commission to employ a notice and comment procedure, with the opportunity for rebuttal. If the Commission elects to retain the paper hearing, however, it should reduce, if not eliminate, the discovery process and any cross-examination or oral argument.

Centel believes that the Commission should not select comparable risk surrogates at this time, but should chose the surrogates at the time the represcription proceeding is undertaken. The Commission should also not limit itself to the surrogates suggested in the Notice. Further, Centel opposes the use of electric utilities as surrogates. The risks associated with providing electric service are substantial less than the risks faced by telephone companies.

Centel supports the Commission's proposal to discontinue using the "historical" discounted cash flow ("DCF") method of determining the cost of equity. That method is not relevant to or consistent with, the forward looking DCF. Moreover, to the extent historical data is relevant, it is reflected in the growth forecasts and current stock prices. With respect to determining the risk premium, Centel prefers the Capital Asset Pricing Model ("CAPM"), but urges the Commission not to codify a CAPM methodology since there is not necessarily a best way to perform that analysis.

Centel agrees with the Commission's proposal to calculate the cost of debt based on the composite embedded cost of debt of the Bell Operating Companies ("BOCs'). It also encourages the Commission to use the actual capital structure of the BOCs for determining the appropriate capital structure of the LECs subject to rate of return regulation. Contrary to the Commission's suggestion, there is no evidence of, or Regional Holding Company ("RHC") incentive to, manipulate BOC capital structure. The BOCs are not subject to rate of return regulation, and, indeed, the increase in their equity ratios reflects the increased risk faced by telecommunications companies. Centel opposes the use of the capital structure of the RHCs, since they have different business and financial risk characteristics.

With respect to the Commission's proposed enforcement mechanisms, Centel agrees with the Commission's tentative conclusion that it should not adopt an automatic refund rule. Centel also submits that the adoption of such a rule would violate the Automatic Refund Decision,[1/] and subsequent decisions in Ohio Bell[2/] and Illinois Bell[3/]. Those decisions establish that the Commission lacks statutory authority to adopt

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[1/] AT&T v. FCC, 836 F.2d 1386 (D.C. Cir. 1988).

[2/] Ohio Bell v. FCC, 949 F.2d 864 (6th Cir. 1992).

[3/] Illinois Bell v. Bell, Case No. 89-1365 (D.C. Cir. June 16, 1992).

such a rule. Indeed, Centel submits that those decisions establish that the Commission may not, even under the complaint process in Section 208 of the Communications Act of 1934, as amended, order refunds for overearnings where it does not allow carriers to recover underearnings.[4/] Construing Section 208 to permit the Commission to order refunds would effectively and unlawfully implement the regulatory regime invalidated by the Court in Automatic Refund Decision, would permit the Commission to set rates retroactively, and would deny LECs the opportunity to earn their authorized rate of return.

Should the Commission conclude, however, that it has the statutory authority to require LECs to pay refunds for overearnings, Centel believes that the Commission must increase the buffer zone from 25 to 100 basis points and should measure a LEC's rate of return over the full period the prescribed return remains in effect. In addition, Centel asserts that the Automatic Refund Decision and the Ohio Bell decision require that any overearnings refunds must be calculated on an overall interstate basis, rather than a service specific basis, and at the total telephone company level. Both decisions require that the determination whether a carrier earned more than its authorized rate of return must be calculated at the corporate level at which investments are made in the LEC.

[4/] Similarly, in Illinois Bell v. FCC, Case No. 89-1365 (D.C. Cir. June 16, 1992), the Court held that the Commission cannot order refunds pursuant to the tariff review process in Section 204 of the Act without first suspending the rates and instituting an accounting order.

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COMMENTS OF CENTRAL TELEPHONE COMPANY

I. INTRODUCTION

Central Telephone Company ("Centel"), on behalf of itself and its affiliated local exchange carriers ("LECs"), hereby submits its comments in response to the Notice of Proposed Rulemaking and Order, FCC 92-256, released July 14, 1992 ("Notice") in the above-referenced proceeding. In the Notice, the Commission proposes to reform the existing rate of return represcription process. Centel supports those efforts. These comments address the Commission's specific proposals concerning initiating represcription proceedings; the conduct of represcription proceedings; the cost of capital methodologies; and the enforcement procedures.

II. DISCUSSION

A. Initiating Represcription Proceedings

The Commission proposes to begin represcription proceedings only when market indicators show significant changes in the cost of capital that are likely to persist over time. Notice at ¶4.

Specifically, the Commission proposes to replace the current biennial trigger contained in Part 65 with a trigger based on changes in the capital markets. Id. at ¶ 9. The Commission requests comment on whether it should adopt an automatic or semi-automatic trigger. Id. at ¶ 25.

Centel supports the adoption of a semi-automatic trigger to determine whether a represcription proceeding should be initiated. A semi-automatic trigger would permit additional analysis to determine whether a represcription is necessary once the triggering event occurs. To be fair and indisputable, the trigger should be readily observable by all parties and not subject to the discretion of the Commission or any other party. The trigger should also be a relevant predictor of changes to LEC capital costs.

Of the numerous measures suggested for the trigger, e.g., various Treasury rates, utility bond yields, discounted cash flow ("DCF") cost of equity estimates, Centel supports the use of the "Aa" rated public utility bonds. This measure is readily available[1/] and is more indicative of LEC financing costs than the other measures, because it reflects the long-term costs of funding utility investments.

A DCF analysis would not be a good trigger. It is not routinely published such that it might be agreed upon as a reasonable proxy for interstate access. It would also be very

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1/ The "Aa" public utility bond yields are published monthly by Moody's Investor Services.

time-consuming and costly to produce DCF studies on a regular basis.[2/]

The Aa utility bond yield is also superior to the 10 year and 30 year Treasury bond rates. The 10 Year Treasury rate fails to provide a consistent measure of changes in the cost of long-term debt and equity financing to a utility. The 30 Year Treasury rate does not consider variations in the premium utilities must pay over risk-free Treasuries in the debt markets.

Centel recommends a trigger mechanism based on a deviation for six consecutive months of +/-150 basis points in the six month moving average of the Aa utility bond yield from a base rate Aa utility bond yield. In addition, the Aa utility bond yield for the most recent month must be at least +/-150 basis points from the base rate Aa utility bond yield for the trigger to be activated. A band of +/-150 basis points around a base rate based on the six month moving average of Aa utility bond yields would provide a reasonable measure of significant and persistent changes in LEC capital costs. The requirement that the most recent month's Aa utility bond yield be at least +/-150 basis points from the base rate would avoid unnecessary represcriptions when changes in the credit markets reverse or

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[2/] Centel does not object to the use of DCF studies as a supplemental analytical tool once the Aa utility bond yield threshold is reached to determine whether a rate represcription is necessary.

correct themselves in the short-term.[3] The initial base rate Aa utility bond yield should be set at the time of the order in this proceeding.

With a semi-automatic trigger, after the triggering events have occurred, other factors would be examined to determine whether a represcription proceeding is warranted. This is an appropriate interim step since it does not necessarily follow that the rate of return should be changed solely because the triggering events have occurred. Capital market conditions can change during a represcription period, but those changes may indicate that the existing authorized rate of return is still reasonable. For example equity and debt cost rates do not necessarily move in a lock-step fashion. In the Notice, the Commission's Exhibit D indicates that equity risk premiums for the lower-half Standard & Poor's ("S&P") 400 vary with respect to public utility Aa rated bond yields. A statistical regression analysis of the equity risk premiums and utility bond yields contained in the Commission's Exhibit D indicates a strong negative correlation between the two, i.e., as the public utility

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[3] For example, assume a base rate Aa utility rate of 9.0%, a six month moving average yield of 10.5% or more for six consecutive months, and a yield of 10.5%, 11.0%, 11.5%, 10.5%, 10.0%, 9.5% for the last six months. Under these facts, the six-month moving average method alone would require a represcription proceeding since the six-month moving average yield was 10.5% or more for six consecutive months. However, by employing the second test recommended here, a represcription proceeding would be avoided since the Aa rates are declining and the Aa utility bond yield for the most recent month is not 150 points above the base rate.

Aa bond yield declines, the equity risk premium widens, and vice-versa.[4/] Thus, a change in interest rates may not necessitate a change in the authorized rate of return.

Centel suggests that, before the Commission conducts a represcription proceeding, it should analyze the rates of interest on futures contracts during the period after which the triggering event has occurred. According to the Expectations Hypothesis of the term structure of interest rates, forward rates of interest, which are derived from the yield curve and reflected in the prices of futures contracts on financial instruments, equal expected future spot rates.[5/] An upward sloping yield curve, which is the situation currently, is an indication that investors expect future spot rates to be higher than current spot rates.[6/] Conversely, a downward sloping yield curve reflects expectations that future spot rates will fall below current levels. Where forward rates of interest indicate that rates are not expected to be significantly different than the base Aa utility bond yield, the Commission may decide not to conduct a represcription proceeding.

4/ See Exhibit 1 attached hereto.

5/ See Brealey and Myers, Principles of Corporate Finance, third edition, p. 834.

6/ On September 9, 1992, for instance, the Over the Counter spot yield on 30-year Treasury bonds closed at 7.25%, while on the Chicago Board of Trade the Treasury bond futures contract for September, 1993 delivery settled at a yield of 7.71%. The futures contract was trading at a spread of almost 50 basis points more than the spot yield reflecting market expectations of higher interest rates.

Consideration of rates of interest on futures contracts is completely consistent with the Commission's desire to utilize forward looking approaches to determine the cost of equity. For example, the Commission is proposing to delete the "historical" DCF formulas for its rules because they are inconsistent with the forward looking nature of DCF analysis. Notice at ¶ 56. In addition, consideration of rates of interest on futures contracts is consistent with the desirability of using a consensus forecast. Rates of interest on futures contracts are a market consensus forecast. Similarly, the Institutional Brokers Estimate System ("IBES") data proposed by the FCC for use in its "classic DCF analysis" are analysts' consensus forecast for earnings growth rates. While some parties may dispute the accuracy of interest rates on futures contracts as a predictor of future spot rates, the fact is that daily, financial transactions are priced in accordance with interest rates on futures contracts. For example, if a LEC were to attempt to lock-in an interest rate today on a long-term debt issue with proceeds to be received one year in the future, the pricing would be based on interest rates on futures contracts and not current market interest rates. Thus, Centel submits that interest rates on futures contracts constitute a valuable indicator that should be considered before initiating a represcription proceeding.

B. Conduct of Represcription Proceedings

Centel supports the Commission's efforts to streamline and simplify the conduct of represcription proceedings by replacing the "paper hearing" system with a notice and comment system. Notice at ¶ 27. The paper hearing system has proven to be expensive, cumbersome and time-consuming. Centel believes that the interest of all parties would be served by replacing that system with one that is more streamlined and efficient.

In particular, Centel supports the establishment of a notice and comment pleading cycle that includes comments, replies and rebuttals. Rebuttals are needed due to the importance of represcription proceedings and the unusually large volume of complex data that can be expected to be submitted in such proceedings. Rebuttals would give parties an opportunity to respond fully to arguments presented in replies.

If, however, the Commission decides to retain paper hearings, it should simplify and streamline them as much as possible. Thus, Centel supports the Commission's proposal to reduce, if not eliminate, discovery by setting forth in advance the documents which must be filed as part of a party's direct case. Notice at ¶ 34. Centel also supports the proposal to expand the Bureau's role in determining what additional information should be produced. While Centel agrees that there is a limited, if any, need for cross-examination or oral argument, it is concerned that the proposed repeal of Sections 64.104 and 64.106 might open the door to suggestions that cross-examination and/or oral argument will be allowed on a routine basis. Consequently, it urges the Commission to make it clear that such procedures are viewed as extraordinary and will be used only in compelling cases.

C. Cost of Capital Methodologies

1. Surrogates for LEC Interstate Access Service

The Commission suggests the use of the Regional Bell Holding Companies ("RHCs"), S&P 400 and the 100 large electric utilities as potential surrogates for establishing the cost of capital for LEC interstate access service. Notice at ¶ 50. Centel believes that the selection of firms of comparable risk should be considered at the relevant time and not specified in advance. Moreover, the comparable firms selected need not include or be limited to those suggested by the Commission in the Notice.

However, Centel would not support the use of electric utilities as a surrogate. Market-based measures of risk indicate that electric utility service is currently of considerably lower risk than provision of telecommunications service. Comparison of beta values (a measure of relative business and financial risk) published by Value Line shows an average of about .60-.65 for electric utilities, versus .80-.90 for the RHCs. Such a difference is too large to be explained by RHC diversification into businesses that are riskier than interstate access.

In addition, credit rating criteria for telephone company debt are much more stringent than for electric utilities, reflecting the higher business risk of telecommunications. For example, S&P's benchmarks for AA credit ratings for the two industries are as follows:[7]

	AA Electric	AA Telephone
Pre-tax Interest Coverage (x)	3.5+	4.5+
Total Debt to Total Capital (%)	Under 46	Under 42
Funds from Operations Interest Coverage (x)	3.75+	6.5+

At this time, therefore, electric utilities are not an appropriate surrogate for determining the cost of equity for interstate access.

Centel does not oppose using the RHCs as a surrogate, so long as appropriate adjustments are made for the effect of cellular valuation on stock prices and cellular dilution on earnings growth forecasts. As noted in the Notice, the Commission recognized and made such an adjustment in establishing the current authorized interstate access rate of return. Notice at ¶ 59.

2. Cost of Equity

Centel supports the Commission's proposal to delete the "historical" DCF formula from the Part 65 rules. Notice at ¶ 56. As discussed previously, historical data are inconsistent with the forward looking DCF model. To the extent historical data are relevant, they will be incorporated in the forecasts for the

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[7] See S&P's CreditReview, October 21, 1991 and February 10, 1992.

growth variable of the DCF model as well as the current stock price.

While Centel supports the use of the DCF model, it does not believe any one formula is best under all circumstances. Therefore, Centel does not support codifying the methods and procedures for the input variables since this renders the model inflexible and closed off from continuing research and findings. However, if the Commission decides to adopt a formula in this proceeding, Centel submits the following comments on the issues raised by the Commission on its "classic" DCF variables having stated its objection to specifying a formula in advance:

<u>Stock Prices</u>: The Commission proposes to use a series of monthly high and low stock prices in its DCF formula. <u>Notice</u> at ¶ 61. If that proposal is adopted, the selected price data should be contemporaneous with the dividend values used. However, Centel does not see any reason why daily or weekly prices could not be used.

<u>Dividends</u>: The Commission proposes to increase the current dividend value by one-half of the IBES growth estimate. <u>Notice</u> at ¶ 62. Centel believes that application of the full growth estimate to the current dividend is most consistent with the textbook derivation of the DCF model.

<u>Growth Rate</u>: The Commission proposes to continue to use the median IBES forecast of long-term growth in the DCF formula. While Centel supports the use of IBES as a source for the growth

component for the DCF formula, it also supports the introduction of other sources such as Zack's, if appropriate.

Quarterly Compounding: The Commission believes that quarterly compounding increases the complexity of DCF calculations and proposes to discontinue using it in any DCF formula. Notice at ¶¶ 64-65. Centel opposes the Commission's proposal. Quarterly compounding can be handled easily by today's computer software. It does not introduce unnecessary complexity to the model. Moreover, quarterly compounding is more appropriate than a simplifying annual dividend assumption since it reflects how companies actually pay dividends in reality.

3. **Risk Premium**

While recognizing the potential merit of risk premium analyses for use in establishing the LEC rate of return, the Commission questions whether the problems experienced during the 1990 represcription proceeding -- unrealistic risk premiums and betas -- will preclude the use of risk premiums in the future. Notice at ¶ 71. Centel acknowledges that there was concern about using historical spreads between common stock returns and long-term Treasury bond yields,[8/] because of the wide range of rates (-49.3% to +45.2%) during the period from 1926-1988. This concern, however, should not create the perception that the average spread between common stock returns and Treasury bond yields is a poor indicator of market expected risk premiums. To

[8/] Notice at Exhibit B.

the contrary, the volatility of realized returns about the mean indicates the considerable risk of common stocks relative to Treasury bonds, and greater volatility commands a higher expected return.

In Exhibit C of the Notice, the Commission attempts to minimize the problems associated with historically-based risk premiums by comparing implied returns on equity from previous rate of return represcriptions with then current 10 Year Treasury yields. Notice at ¶ 73. The Commission's analysis is flawed for two reasons. First, the most critical flaw is the inherent circularity of using a previously prescribed return on equity to prescribe the return on equity for the proceeding at hand. This assumes that the previously prescribed returns on equity were correct in those prior proceedings and that no other factors besides the yield on 10 year Treasury bonds has changed since the time of those proceedings.[9/] Second, 10 Year Treasury bonds are not an appropriate benchmark. The benchmark used by the Commission should have a duration more comparable to the infinite maturity of common stocks, such as 30 Year Treasury bonds or Aa utility bond yields.

[9/] A similar circularity problem also exists in the Commission's comparison of Aa utility bond yields and DCF rates of return in Exhibit D of the Notice. The DCF model and risk premium model should be developed independently; otherwise, any estimation or model specification errors inherent in the DCF model as applied to prior periods will carry over into the risk premium model results.

Of the risk premium methods available, Centel prefers the Capital Asset Pricing Model ("CAPM") to the alternative "implied" risk premium approaches illustrated in Exhibits C and D of the Notice. The CAPM adjusts the equity premium for differences in risk vis-a-vis the market, and thus provides an independent and more reliable measure of the cost of equity. However, the Commission should not codify a risk premium or CAPM methodology for purposes of represcription since there is not necessarily a best way to perform such analyses under all circumstances.

4. Cost of Debt

The Commission plans to consider five methodologies for calculating the cost of debt component. Notice at ¶ 77. Centel supports using the composite embedded cost of debt of the Bell Operating Companies ("BOCs"). Centel's support for that methodology is consistent with its support for the use of the BOCs' capital structures, as discussed below. Regarding calculation of the cost of debt, Centel supports the use of the interest method, which is consistent with generally accepted accounting practices and maintains the implicit interest rate over the life of each issue. In addition, Form M reports contain sufficient detail to compute the cost of debt in this manner.

5. Cost of Preferred Stock

The Commission seeks comment on whether it should codify a method for calculating the cost of preferred stock. Notice at ¶82. If the BOCs' capital structures are used, a method for computing the cost of preferred stock would be unnecessary since the BOCs have no preferred stock. If the Commission utilizes a capital structure that includes preferred stock, Centel supports the use of a methodology that is similar to determining the cost of debt.

6. Capital Structure

The Commission seeks comment on alternatives for determining an appropriate capital structure for the interstate access operations of the remaining rate of return LECs. Notice at ¶ 84. Centel recommends utilizing the composite capitalization of the BOCs. Contrary to the Commission's suggestion, there is no evidence of, or RHC incentive, for manipulation of BOC capital structures at either the interstate or intrastate level. Indeed, that contention is irrelevant with respect to interstate access since the BOCs are all subject to price cap regulation and are not subject to the represcription process. Further, the BOCs issue their own debt, rated separately from the RHCs debt, which supports interstate access. As a result, the BOCs must maintain their capital structures in accordance with market-determined levels if they are to obtain debt at a reasonable cost.

Compared with the composite BOC capital structure, there is little gain in precision but a significant increase in administrative burden to develop the composite capital structure of Tier 1 LECs. Also, there would presumably be more concern about capital structure manipulation if the non-price cap, Tier 1 LECs -- which are directly subject to the rate of return represcription -- were included in the capital structure composite. While Centel believes that concerns about such manipulation are unfounded, these factors further support the use of the BOC capital structure. However, if the Commission decides not to use that structure, the Tier I LEC composite is the second best approach.

The use of the RHCs' capital structures should be rejected. To use the RHCs' capital structures, as the Commission has done in the past, would only cloud the determination of the cost of providing interstate access by introducing debt issues and capitalization policies related to nonregulated business ventures. Those ventures have different business and financial risk characteristics from those related to the provision of interstate access.

The Commission has acknowledged that the composite BOC capital structure is "well within the limits traditionally considered acceptable for regulated telephone operations," even though the BOCs and LEC subsidiaries of independent holding companies have been slowly increasing their equity ratios since divestiture. Notice at ¶ 83. This adjustment in equity ratios is not evidence of manipulation, but rather, appropriate recognition and response by the LEC industry to increasing business risk and the need to maintain stronger capital structures to support credit ratings. According to S&P, as competition evolves, LECs will demonstrate higher risk profiles, similar to those found in the ratings of industrial companies.[10] S&P has imposed tougher benchmarks for its various debt ratings of local exchange telecommunications companies. Even though equity ratios have strengthened, the BOCs and independent LECs have at best maintained their credit ratings, but more often they have experienced downgrades. Indeed, the dramatically changed telecommunications industry and regulatory environment, Notice at ¶ 1, are reflected in the BOCs' capital structures, and it would be inappropriate to use other capital structures that do not reflect the dynamics of the industry.

Finally, state regulators have the ability to impute capital structures if they find the LECs' actual capital structures are contrary to the public interest. This ability removes the incentive for RHC manipulation of the BOCs' capital structures at the intrastate level.

7. State Cost of Capital Determinations

The Commission believes that state cost of equity determinations can be useful in assessing the reasonableness of other cost of capital estimates. Notice at ¶ 89. Centel disagrees. State cost of capital determinations should not be used as a test of reasonableness for interstate access. The comparison of state cost of equity determinations with other cost of capital estimates would be rendered inconclusive since each

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[10] See S&P's CreditReview, June 24, 1991.

state regulates LECs in a different manner and LECs in each state face varying degrees of competition.

D. Enforcement Procedures

The Commission seeks comment on its tentative conclusion that it should rely on the tariff review and complaint processes to enforce its rate of return prescriptions and that it should repeal the automatic refund rule. Notice at ¶ 98. The Commission also seeks comment on whether it should supplement the tariff review and complaint processes with a new automatic refund rule, although it questions the need for such a rule. If such a rule is adopted, the Commission seeks comment on whether refunds, under the new rule, should be calculated on an overall interstate access basis, rather than on an access category basis. Id. at ¶¶ 99-100. Finally, the Commission seeks comment on whether different buffer zones and enforcement periods would address the concerns expressed by the Court in the Automatic Refund Decision.[11]

1. An Automatic Refund Rule is Unnecessary and Unlawful

Centel fully concurs with the Commission's tentative conclusion that it should not adopt an automatic refund rule. While Centel agrees with the Commission that the limited number of LECs subject to rate of return prescription renders such a rule unnecessary, it also believes that the proposal suffers from

[11] AT&T v. FCC, 836 F.2d 1386 (D.C. Cir. 1988) ("Automatic Refund Decision").

a more fundamental defect: the Automatic Refund Decision, and subsequent decisions in Ohio Bell[12] and Illinois Bell,[13] establish that the Commission lacks the statutory authority to adopt such a rule. Indeed, Centel submits that the those decisions establish that the Commission may not, even under Section 208 of the Communications Act of 1934, as amended ("Act"), order refunds for overearnings where it does not allow carriers to recover underearnings.[14] Construing Section 208 to permit the Commission to order refunds would effectively implement the regulatory regime invalidated by the Court in Automatic Refund Decision, would permit the Commission to set rates retroactively, and would deny LECs the opportunity to earn their authorized rate of return.[15]

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[12] Ohio Bell v. FCC, 949 F.2d 864 (6th Cir. 1992) ("Ohio Bell").

[13] Illinois Bell v. FCC, Case No. 89-1365 (D.C. Cir. June 16, 1992) ("Illinois Bell").

[14] Similarly, in Illinois Bell, the Court held that the Commission cannot order refunds pursuant to the tariff review process in Section 204 of the Act without first suspending the rates and instituting an accounting order.

[15] Overearnings refunds also raise the question of whether a refund would constitute an unconstitutional taking of property. The Court in the Automatic Refund Decision declined to address this issue, although it implied that the Commission's refund mechanism might be unconstitutional on that basis. Automatic Refund Decision, 836 F.2d at 1391-92.

a. **The Commission Lacks Statutory Authority to Adopt any Rule that Would Require LECs to Issue Refunds for Overearnings but Precludes Them From Recovering Underearnings**

In the Automatic Refund Decision, the Court held that the Commission's automatic refund rule was inconsistent with the rate of return prescription adopted in Phase I of CC Docket No. 84-800, as well as with traditional cost of service ratemaking principles and historic Commission policies. The Court noted that the Commission had consistently and correctly declared that a rate of return prescription is the "necessary minimum" that can be prescribed and that any lower rate would risk exposing the carrier to capital flight due to earnings insufficient "to retain the carrier's capital investors and to attract additional required investment." Automatic Refund Decision, 836 F.2d at 1390. See United States v. FCC, 707 F.2d 610, 612 (D.C. Cir. 1983); Nader v. FCC, 520 F.2d 182, 202-04 (D.C. Cir. 1975). See generally F.P.C. v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944).

In order to avoid the dictates of the Automatic Refund Decision, the Commission has attempted in the Notice to "clarify" its previous position that a rate of return prescription is "both a maximum and a minimum". Notice at ¶ 96. Under this approach, the rate of return is "a point within a broad zone of reasonableness. This point is neither the maximum nor minimum